



## CONSULTING ASSISTANCE ON ECONOMIC REFORM II

# DISCUSSION PAPERS

The objectives of the Consulting Assistance on Economic Reform (CAER II) project are to contribute to broad-based and sustainable economic growth and to improve the policy reform content of USAID assistance activities that aim to strengthen markets in recipient countries. Services are provided by the Harvard Institute for International Development (HIID) and its subcontractors. It is funded by the U.S. Agency for International Development, Bureau for Global Programs, Field Support and Research, Center for Economic Growth and Agricultural Development, Office of Emerging Markets through Contracts PCE-C-00-95-00015-00 and PCE-Q-00-95-00016-00. This paper has been funded by contract PCE-C-00-95-00015-00, Task Order 23. Copyright 2000 by the President and Fellows of Harvard College.

### **A Symposium on Trade, Trade-led Growth, and Foreign Direct Investment**

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Development Assistance in the Twenty-first Century:  
Challenging the Conventional Wisdom on Assistance and Development

Plenary Session 4

**A Symposium on Trade, Trade-led Growth, and  
Foreign Direct Investment**

**Steven Radelet, Lynn Salinger and Glenn Jenkins**

October 1, 1999

This paper is an edited version of the transcript from a panel presentation by Steven Radelet (HIID), Lynn Salinger (AIRD), and Glenn Jenkins (HIID) at the Consulting Assistance on Economic Reform II Project conference “Development Assistance in the Twenty-first Century: Challenging the Conventional Wisdom on Assistance and Development.” Each of the presenters summarizes main findings from their CAER II Discussion Papers. These papers are Nos. 42 (Salinger), 43 (Radelet), and 65 (Jenkins) and are available from the project web site: <http://www.hiid.harvard.edu/projects/caer/index.html>.

The original transcript and audio of the session are available from the conference web site: <http://www.hiid.harvard.edu/groups/macro/da21>. The editors have made every effort to preserve the original meaning of the presenters and participants, although language has been altered to make the paper more clear.

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**Presenter #1: Steven Radelet**

The term “export platforms” includes export processing zones (EPZs), but is also a broader definition that includes other facilities that are designed to help manufactured exports, including bonded warehouses, duty drawback systems, duty rebate systems, duty exemption systems, and other kinds of facilities. Expanding the scope of discussion to encompass all of these facilities allows us to think of them as different alternatives and substitutes in some sense, and complements in some sense.

The question is why they work sometimes and not others, and why they might be important in some countries. Discussion Paper 43 is based on eight country studies, including country studies in the Dominican Republic, Mexico, Tunisia, Kenya, Ghana, Thailand, Singapore, and one study that encompasses five countries in Central America. These individual in-depth country studies allow us to examine what was really going on in that country and why these export platforms worked in some places and didn’t work in other places.

The first point is to emphasize the importance of manufactured exports in economic growth. It is now fairly widely accepted that there is a very, very strong relationship between the countries that have been successful in manufactured exports and the countries that have been successful in overall economic growth. Table 1 shows that the countries that are the top performers in economic growth are almost always the countries that have been the top performers in terms of manufactured exports. The first column lists the top ten performers over the last twenty-five years, in non-primary manufactured exports; that is, manufactured exports excluding those that are based on primary products, like diamonds, for example. Also excluded are products such as plywood, iron, and steel, which are based on primary products.

Basically all of the countries that have been successful in stimulating non-primary manufactured exports have all been top performers in terms of economic growth. There is a long literature on why manufactured exports would help growth. The usual reasons given are that it increases competition, increases specialization, and provides opportunities for firms to get plugged into the global production network, thereby serving as a conduit for technology, both in terms of new machinery and new production techniques. This long literature basically debates why exports may or may not be beneficial. While Discussion Paper 43 does not focus on this debate, it builds on the foundation provided by this body of literature.

<b>Table 1 : Low and Middle Income Country Exporters of Non-Primary Manufactured Products</b>		
<b>Top 15 Performers, 1970-96 *</b>		
	Non-Primary Manufactured***	Average Growth Rate of
Country	Export Growth Rate **	Real GDP Per Capita (PPP\$)
Singapore	14.93	6.98
Taiwan	5.61	6.51
Hong Kong	5.58	5.63
Malaysia	4.73	5.40
Ireland	4.61	3.56
Korea	4.43	7.37
Mauritius	2.90	3.93
Hungary	1.95	1.55
China	1.91	5.01
Thailand	1.86	4.96
Portugal	1.76	3.91
Tunisia	1.66	3.31
Israel	1.41	2.61
Sri Lanka	1.33	2.68
Dominican Republic	1.10	2.13

Notes: Table is from Discussion Paper No. 43

\* Includes countries with 1990 population greater than 1 million and GDP per capita (PPP\$) of less than \$7,000 in 1970.

\*\* The non-resource based manufactured exports weighted growth rate is equal to the annual growth rate of those exports times their share in GDP in the previous year.

\*\*\* The non-resource based manufactured exports include commodities in SITC 5 through 8 except SITC 61, 63, 66, and 68.

Another body of literature describes the policies that are necessary to support manufactured exports. I think that literature is largely correct, but generally incomplete. It is correct in pointing out the importance of macroeconomic stability, infrastructure for manufactured exports (such as good roads and good ports), an appropriate exchange rate, education, political stability, trade liberalization, and tariff reduction. These are all important, but insufficient, conditions to guarantee the success of manufactured exports. No country that has adhered to just this set of policies has been successful in manufactured exports. All of the successful exporters have set up institutions to help stimulate and facilitate exports, such as export processing zones, duty exemptions, and bonded warehouses. We find no country that has been successful in the last fifteen years without those facilities, a conclusion that is largely left out of the literature on export-promotion policies.

There has been significant debate about why Asia was so successful for such a sustained period. These export platform facilities are one of the clear common denominators across every single one of the successful Asian countries. Hong Kong and Singapore, which are basically export processing zones, China, Taiwan, Korea, Malaysia, Indonesia, and most recently the Philippines have all had them, as well as countries like Mauritius, and more recently the Dominican Republic and Costa Rica. It's hard to think of a country that's been successful in manufactured exports without these types of facilities.

These are not free market institutions or market outcomes. This is not a situation where once you get prices right the private sector will do this. These are government-led institutions in every case, in the sense that the government has to establish the legislation to create them. Some EPZs are, of course, privately owned, but they are still not just general market outcomes. The government has to play a role. These are designed actually as what economists call "second best outcomes." They are designed to overcome distortions that remain in the rest of the economy that undermine exports. We know that low tariffs are good for exports, because we know that exporters have to be able to buy their imports at world prices if they are going to compete on world markets. But we also know that trade liberalization to reduce tariffs across the board is really hard, and cannot be done in most countries overnight, or even over a couple of years. It is a long, gradual process because of the political economy involved. Altering foreign investment rules and building infrastructure also take time.

If a country starts at a position where there are lots of problems and knows that five or ten years from now it wants to have a good policy situation for exports, the issue is what to do between now and then. That is what these export platform facilities are for. They are set up primarily to provide a way for exporters to get their imports duty-free. All of them have that common denominator, but some of them go beyond to provide the infrastructure, power, or administrative facilities. Most of them have customs clearance facilities as part of the operation to expedite the usual customs bureaucracy. A country can either completely clean up customs or give this sort of short cut for at least some exporters. While it would be nice to completely clean up customs, it is really hard to do. So in the meantime, countries should at least have a facility that gets some of the most important firms access to imports easily.

So export platform facilities are set up to shortcut the system slightly in order to get around some of the distortions that exist. That is why these zones are called “enclaves”. They are an enclave away from many of the distortions that exist in the rest of the economy, with the idea that as the enclave spreads over time, those other distortions in the economy begin to take care of themselves. So over time, these export platforms become less important. If you look at Taiwan and Korea, for example, these facilities were absolutely critical twenty years ago. Twenty years ago, there were no manufactured exports from those countries that did not go through one of these facilities. Now that is not the case because there is broader infrastructure, the tariff structure is much lower and FDI rules are more broad-based. Firms do not need to be in the EPZs any more, like they did twenty years ago. EPZs are temporary solutions, although temporary may be two decades, in order to get around the distortions that exist in the rest of the economy.

Every successful manufactured exporter has at least one of these facilities, and most manufactured exporters have more than one. Almost all the successful countries have export processing zones and duty exemption systems and bonded warehouse facilities because they give firms a choice. Some firms want to be in an export processing zone because they need the location near the port and they need the infrastructure. For some firms, that’s less important; they want to be able to locate near whatever their input supply is, so they want to be somewhere else. For them, a bonded warehouse system or a duty exemption system might work best. But in the successful countries, there are multiple facilities, and firms are not told where to locate. They are given the choice, or there might be competition between export processing zones. In the Philippines now, there is intense competition between zones over who can offer the best facilities. The same competition is evident in Mexico among the maquiladoras, which are basically bonded warehouses. So they give firms a choice about what might be the best system.

However, the fact that these facilities are consistently seen in all of the successful exporters is not the same thing as saying that these facilities are always successful, because they are not. There are many examples where export processing zones, duty drawback or exemption systems, or bonded warehouse systems have failed. So one of the questions is why these facilities fail. One critical reason is the failure to get the macroeconomics right. A country can have a very nice export processing zone, but if its exchange rate is overvalued it will not have much luck in terms of exports. One of the best examples of that right now is Egypt, which has some good facilities, but an overvalued exchange rate and therefore cannot compete. The Dominican Republic has had export processing zones for many years, but when the macroeconomic situation was not very good and there was more political instability, the zones didn’t work. In the last six or seven years as the macroeconomic situation has improved, the exchange rate is no longer overvalued, and some of these other problems have been taken care of, the zones have been quite successful. Simply having the zones is not a silver bullet; one still has to have the basic infrastructure and macroeconomic policies in place.

There are several controversial issues about these zones. One critique is that EPZs have no links to the rest of the economy. Sometimes that is the choice of the foreign investors that come in because they do not want to have any links. But often it is actually not a problem with the facility itself but rather a reflection of the problems in the rest of the economy. Firms that are located in EPZs are not going to buy high-cost, low-quality inputs from the rest of the economy, because

then they cannot compete. The solution to those kinds of problems is to make sure that the domestic importers can get their imports duty-free and can become themselves competitive on world markets, so that they can supply the exporting firms. Korea, Malaysia, Indonesia, and a few other countries have had a lot of success in extending these kinds of enclaves to domestic suppliers, but it's tough. There are also issues about wages and the composition of exports, which are part of a broader story about manufactured exports that says that this strategy will get a country stuck with low wages, low productivity, and low technology goods. The evidence is overwhelmingly against that. The countries that have pursued manufactured exports and stuck with this strategy have had the fastest wage growth in the world in the last thirty years, as shown in Table 3. Also the countries that have done this have not been stuck in low technology exports, but have moved from low technology up through electronics, to high technology over time, without any evidence of "getting stuck."

<b>Table 3: Real Earnings Per Worker in Manufacturing</b>													
<b>(domestic currency, Index 1980=100)</b>													
	High Growth of Manufactured Exports									Medium Growth of Manufactured Exports			
Year	China	Hong Kong	Ireland	Korea	Mauritius	Portugal	Singapore	Thailand		Indonesia	Israel	Mexico	Sri Lanka
1975		77.0	91.5	57.9	81.2						78.5	97.7	74.9
1976		85.9	89.1	67.6	96.5						83.3	106.2	74.8
1977		90.1	91.3	82.2	108.2						88.1	107.7	108.4
1978		96.0	98.1	96.4	116.8						91.4	105.5	145.9
1979		101.1	102.4	104.9	107.0						98.6	104.3	113.9
1980	100.0	100.0	100.0	100.0	100.0	100	100.0	100.0		100	100.0	100.0	100.0
1981	98.1	101.6	99.2	99.0	97.5	102	100.8	105.8		98	111.6	102.5	87.0
1982	98.0	127.3	96.9	105.9	93.4	102	105.8	113.1		111	113.7	101.1	77.2
1983	98.0	127.4	97.4	114.9	93.1	99	114.0	109.7		113	118.0	74.2	78.1
1984	115.2	133.1	99.4	121.5	92.1	90	121.1	173.2		118	122.5	71.3	77.8
1985	115.6	140.3	101.5	130.4	89.5	91	131.5	175.9		124	109.8	64.8	88.3
1986	124.2	147.2	104.8	138.6	96.2	98	145.4	160.8		130	121.1	58.2	86.7
1987	128.6	156.9	106.1	150.6	101.5	105	149.5	164.0		127	133.3	60.1	88.6
1988	136.2	167.5	108.3	167.5	110.0	111	162.9	163.7		138	137.9	56.8	88.6
1989	129.2	175.1	108.3	198.4	112.2	117	177.3	163.3		146	139.2	58.2	88.4
1990	131.0	182.4	110.0	219.5	109.7	125	192.3	173.2		179	135.1	58.9	94.1
1991	138.9	183.7	111.9	234.4	121.6	135	206.8	179.5		172	131.1	60.6	102.7
1992	149.9	182.5	114.0	255.5	126.7	142	219.8	163.0		166	133.6	64.4	96.2
1993	166.3	185.6	118.9	270.1	125.9	139	231.6	187.2		158	132.9	65.4	95.9
1994	171.2	188.5	117.1	293.9	137.3	136	246.6	182.1		154	133.8	61.8	101.9
1995	176.8	180.2	117.5	309.1	141.9	137	262.1	203.5		162	139.0	51.9	102.2
1996	178.1	180.8	118.8	330.6	140.6	141	278.0			152	143.4	47.2	91.7

Source: Nominal Earnings are from Yearbook of Labour Statistics and the CPI data are from IFS (except for China from Asian Development Bank).

High growth means average annual weighted growth rate more than 1.5% for period 1970-96.

Medium growth means average annual weighted growth rate between 0.5% and 1.5% for period 1970-96.

Table is from Discussion Paper No. 43.

<b>Table 3 (continued): Real Earnings Per Worker in Manufacturing</b>									
<b>(domestic currency, Index 1980=100)</b>									
	Low Growth of Manufactured Exports								
Year	Argentina	Bolivia	Chile	Jordan	Kenya	Malawi	Philippines	South Africa	Zimbabwe
1975	243.5	87.8	35.5	78.0	122.0			91.5	95.9
1976	136.2	84.0	44.5	112.4	116.5			87.9	91.6
1977	108.6	106.4	65.0	100.2	112.3			91.0	91.4
1978	77.3	78.2	79.8	118.2	100.9			98.5	94.9
1979	80.5	135.1	88.1	113.7	98.6			99.4	88.7
1980	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1981	114.9	89.9	112.2	110.7	99.6	100.2	101.1	105.9	109.4
1982	115.4	65.2	112.6	114.7	91.7	133.0	101.8	112.0	114.1
1983	157.0	87.5	119.3	115.5	89.1	94.0	105.8	112.8	105.4
1984	175.4	50.3	115.7	112.5	88.6	71.3	92.6	116.4	98.3
1985	146.1	71.2	106.0	118.4	82.4	80.3	89.4	113.1	103.2
1986	159.0	48.6	106.0	123.7	84.7	79.1	99.3	107.8	97.7
1987	140.7	68.8	103.6	133.5	86.9	78.4	111.1	106.6	97.3
1988	144.6	78.9	109.8	116.8	84.1	63.2	120.6	109.8	101.3
1989	109.7	80.6	114.0	97.4	84.3	60.9	123.5	113.4	101.2
1990	131.2	77.7	115.6	87.6	79.9	65.5	134.1	114.4	103.1
1991	116.3	79.4	123.5	81.0	72.4	50.9	128.0	113.0	97.5
1992	105.5	79.4	130.8	80.6		45.0	131.0	115.2	83.0
1993	101.3	81.2	134.2	80.5		38.9	126.2	117.0	72.0
1994	104.4	88.2	146.6	81.7		30.7			73.9
1995	103.7	86.1	152.2	81.5		17.8			74.0
1996	108.6	87.3	157.5						70.8

Source: Nominal Earnings are from Yearbook of Labour Statistics and the CPI data are from IFS.  
Low growth means average annual weighted growth rate less than 0.5% for period 1970-96.



**Presenter #2: B. Lynn Salinger**

I'd like to share with you this morning some work that I've been doing with colleagues, Maggie McMillan from the Department of Economics at Tufts University, and my colleague from AIRD, Selina Pandolfi. I would like to describe four different areas related to world markets. First, I would like to talk about global patterns of export development and integration into export markets. Second, I want to explain why we focused on labor-intensive manufacturing. Third, I'd like to explain some of the factors that we found were driving allocations of foreign direct investment, and some of the other relationships that we uncovered as well. Finally, I want to assess the implications of all of this for U.S. and partner country development policies.

Steve talked to us about the wide diversity of institutional incentives available to many countries today, as they seek to integrate their economies into world markets. I would suggest that there's been a sort of phasing, and I think Steve touched on this too, a phasing that different countries have used as they have sought to become more involved in export-led growth. When economies are terribly distorted, you start with that physical export enclave. But over time, as you develop more stakeholders who have an interest in the promotion of exports, you're able to broaden those reforms throughout your economy to the point where we now have wide access to export incentives available in many developing countries around the world.

Here we are in the 1990s, and the question is: How do these countries now compete as they seek to place their exports on international markets? They are, in fact, competing for access to international partners. So our initial hypothesis as we started this work was that not all countries are at the same stage and that, in order for those laggards to promote trade and growth today, developing countries should be focusing their efforts on attracting foreign direct investment into footloose labor-intensive manufacturing industries. Why labor-intensive? Because we figured that "labor-intensive" means employment generation. Why manufacturing? Because we figured that was a way of moving economies from a focus on the export of primary commodities into processed and industrialized goods. Why exports in general? For all the reasons that Steve has just enumerated for us.

But what do we mean by footloose industries? The textbooks tell us that footloose industries are those, for instance, with low capital requirements. It doesn't take much investment in sewing machines or soldering tables to get your assembly operations started overseas. We're also told that these are industries that have minimal skilled labor requirements. You don't need to invest in heavy training of workers to teach them how to sew a seam on a pillowcase, or to teach them in theory how to solder parts together. We also have a notion that footloose industries are facilitated today by what is called by some in literature, 'the death of distance,' by which we mean the dramatic decrease in the costs of international telecommunications and transport, which allows industries to casually move from one place to another.

There are certainly examples of footloose operations around the world. In work that I did a few years ago in the textile and clothing industry in South Africa, we heard of Taiwanese clothing firms that were lured into South Africa on the strength of what were known as "decentralization

incentives.” These were fiscal incentives offered to outside firms in order to promote location of operations out near homeland fringes instead of in urban centers in order to maintain populations in certain geographic areas. As the apartheid government retreated from that incentive program and as the government changed, Taiwanese firms threatened to pack their sewing machines and get on the next flight out of South Africa if those monies were not available (and some did). We also know that through the history of the multi-fiber arrangement, many East Asian clothing manufacturers have moved from one country to another, as they seek new country production platforms, which have not used up their quotas to importing countries; and they move their operations there.

However, as we talked to firms in both the electronics and the clothing industries, we also were aware that many of these companies have had longstanding operations in countries. We heard stories of 20-year relationships with clothing suppliers in the Philippines and of longstanding relationships on the northern border of Mexico. So I think it's an over-simplification to talk of these industries necessarily as footloose.

We focused on the electronics and apparel industries. Maggie was in charge of looking at what was essentially computer and computer component companies here in the U.S.; Selina and I looked at apparel manufacturers. As we spoke with firms, you can guess what their first order allocation criteria were. They're all the reasons that Steve just mentioned a moment ago that would bring someone into a new country. You have a stable macroeconomy. You have low favorable tariff rates on your imported inputs. You have decent infrastructure. You have some semblance of social and political stability, some measure of legal and regulatory transparency.

But the point is that many countries offer this kind of a framework, so how are they to compete for foreign market partners? It's either on the strength of tax or fiscal incentives, or it's on the basis of what I would call “qualitative competitiveness issues.” I think it's important here to stress that while cost differentials still matter as you choose one country or another as your choice platform, production costs are actually a small percentage of overall cost to the final consumer. Firms are becoming selective. U.S. firms are now becoming very selective, in terms of demanding high-quality work forces, for example, of their partners overseas. Growth in trade, therefore, is not just related to foreign direct investment. But it's dependent on the commercial linkages that are being woven together in what many are calling “global production networks.”

As we spoke increasingly with firms, we realized that equity participation in overseas affiliates was actually becoming an expensive way for them to do business. These global production networks, or webs of commercial relationships among designers and merchandisers, suppliers, producers, subcontractors, and ultimately the buyers and retailers in the industrial country markets, now dominate the organization in trade for many of the consumer goods being produced in the world today. Why invest in a new plant? Why set up a brand new factory if thriving private sectors in many countries overseas are now capable of supplying you with reasonable product quality in adequate volumes according to your timetable? Furthermore, they are able to adapt production specifications to ever changing consumer tastes and demands.

We thought it was important to understand what drives these industries overall, in order to draw insights for the kind of qualitative issues that developing country firms need to focus on. So

Maggie, in her work in the computer industry, spoke to quite a few firms, and first came to the realization that large, vertically organized corporations no longer dominate production in this sector. Rather, there's a myriad of competitors who are seeking to supply U.S. merchandisers with everything from chips and code and assembled motherboards to monitors and keyboards. These merchandisers are specializing either upstream, on the research and development side of product design, or downstream, on the merchandising of these assembled products to the end consumer. Ever shortening product cycles are forcing overseas partner firms to be able to handle quick redesign of product specifications. And we also see that manufacturing is increasingly being differentiated from technology. Research and development has become one of the key competitiveness factors in this market, and thus we see the protection of that key kernel of competitiveness. Intellectual property rights debates are becoming important, and companies are evaluating which countries to enter partly on the strength of their intellectual property laws.

In the apparel industry, you see a different story. Whereas product research and development may be the key to competitiveness for computers, in the apparel business the concentration, and thus the key area of competitiveness, is really at the retail level. Retailers in the United States, or in the industrial country market, are increasingly calling the shots in this commodity chain, thereby leaving the traditional brand label clothing firms out of the picture in many instances. They're setting up their own private label companies to compete, subcontracting with a myriad of people overseas to provide product for them.

And the key to competitiveness in this chain is really who has the best information technology. The POS means 'point of sale' data. The moment you purchase an item, the retailers are monitoring what you're buying, when you're buying it, and how much you're buying of it. So they feed that information back up to their suppliers. In fact, in the work that I did in South Africa a few years ago, one of the hallmarks of best practice as we looked across firms was the extent of computerization of firm's operations. Information technology is critical at so many points in the chain in this industry, whether it's computerized design and manufacturing, or computerized control of both input and final product inventory. Some firms are using Web or Internet-based systems, in order to give their clients access to order information ("When am I going to get that product?" and so forth). However, I think it's also important to stress that product innovation can still overwhelm efficiencies along the chain. Think of what a difference in the U.S. market the innovation of Polartec has made in the sporting goods clothing market in this country. Think of how consumers' taste for wide-leg dungarees has threatened the traditional narrow-cut denim jeans market. Product innovation and monitoring consumer tastes is still an important function for merchandising firms here. But I would also suggest that as we work up along the commodity chain, that work multi-skilling is still vital. It's important to get workers to think smarter, so that they are multi-skilled and able to fill in at different steps along the assembly process, and perhaps even to suggest ways to improve quality delivery.

So where we started thinking about foreign direct investment, we realized that there were so many other factors that really affected whether developing country firms were successfully plugging into export markets. And this point of labor quality and innovation is critical to that success. But I would emphasize here that when we're talking about labor quality, we're not just talking about getting improved literacy or numeracy skills to your unskilled worker base, although that is important. It's no longer about how cheap your workers are. It's how skilled

they are, and how skilled they are all points along the chain. It's just as important for managers to have skills in product design, in arranging financing, in negotiating deals with contractors and clients overseas, in managing costs, in handling the logistics of getting your product out to market. So we started to think about the implications of all this for development assistance strategies, in the sense that workers are no longer to be thought of as disposable commodities, but as assets in which to invest in order to promote competitiveness.

So there are two big implications that we see coming out of this work: one with respect to human capital development, the other with respect to U.S. trade policy. With respect to human capital development, we think that it's important for developing countries and for their partners to figure out how to develop competent, creative work forces. But we need a system approach that's going to allow us to do that, that takes input from all participants in the process: from learners, from educators, from workers, from employers, from government policy people, and others. We also think that it's important to promote lifelong learning for global competitiveness, to think about how to give workers and employers access to information and opportunities to enhance the development of their skills and knowledge, so that they're able to participate in value-adding productive work throughout their lifetimes.

Finally, as a last point, I'd like to talk about policy coherence, a topic that was raised by Inge Kaul from the United Nations development program. Policy coherence, Ms. Kaul said, isn't just about developing countries reforming their economies and opening up to imports; it's also about us in the industrial markets doing our part. There are a number of hard decisions that I think U.S. policy makers are going to have to make about our own economy, if we're serious about promoting labor-intensive manufacturing in developing countries, and if we're serious about getting those U.S. firms out into the global marketplace working with them. One is accepting the hard fact that globalization means that trade reform is going to hit all sectors of the economy, and that we're going to be increasingly importing everything from high-value horticulture to a wide range of textiles and garments products.

Another point that I think will be important is a need for consensus on labor codes. In my discussion with a spokesperson from the AFL-CIO, I was reminded that, in fact, most countries in the world are already signatories to international labor conventions. Such conventions address the abolition of forced labor and child labor, freedom of association, and nondiscrimination and equality in the workplace. However, firms told us that there is less consensus in the U.S. market about what we mean by fair working conditions and fair wages. U.S. consumers' concerns about those issues are making it difficult for manufacturing firms to think about going into new countries, unless they're absolutely sure that those countries are upholding certain standards.

As a third point, I think we need to consider extending preferential U.S. market access to our most vulnerable trading partners. Specifically, we need to promote the Africa Growth and Opportunity Act, which appears to be eternally doomed in the U.S. Congress. It would offer, among other things, duty-free access to African exporters of textile and garment products to the U.S. market. This Act is being lobbied against quite heavily by our own textile and clothing industry.

Finally, I think it's critical that we build trade negotiation capacity in our overseas partners. It's not enough to say that you need to take part in these things. Many parts of African civil society, for example, are currently on record as opposing any extension of powers of the WTO to be taken up in the new Seattle round. I think, in part, it's because we haven't done enough work training partners in the strategic approaches they might utilize to request and offer processes that could actually bring some meaningful market-access gains for them. So, human capacity development and U.S. trade policy are two of the implications that we draw from this work.

### **Presenter #3: Glenn Jenkins**

I first want to thank George Kuo who has really done all of the work on this. He'll answer the tough questions!

This issue of promoting export-oriented foreign investment in developing countries is like a system design approach. In order to address the various aspects of the tax system, I thought it would be useful to look at the work George and I have done on the Taiwan case. This represents a good example of the successful manufactured exporter over a long period of time. We've looked at various periods from 1955 through 1995. We look at the value of different kinds of fiscal provisions. In other words, what's the relative value of getting exemption from duties and indirect sales taxes on imports, as compared to the whole package, the whole menu of income tax incentives?

For apparel, the exemption from the duties and sales taxes (indirect taxes on inputs) is 16 times as important in terms of dollars as all the income tax incentives combined. For televisions, it was 25 times as important.

Most people don't know what an indirect tax is. If you go to the street corner of any developing country and shout, "Tax," everybody thinks of the income tax, even though it usually only collects maybe 5 to 10 percent of total taxes. The indirect tax is where the real bucks are, and that's what we have to deal with.

What does this mean in practical terms? In practical terms, the value-added tax is really the dominant indirect tax. It's in 120 countries, and more to come. We need to find an effective refund system for the value-added taxes paid on the input to exporters. In other words, when the exporter buys inputs, they pay a value-added tax. Because exporters are zero-rated on their output and don't owe any tax, we somehow have to get the input tax back to them in the way of refund.

The second question is: How do we remove the burden of tariffs on imported inputs used to produce exports? The third question is: How do we determine what kind of income tax incentive might have a positive impact? Maybe we can do a little better than 25 to 1.

Let's look at the first question, the vast import credit refunds to exporters. In other words, I think in approaching each of these issues, we really need to understand what is the likely behavioral response of rent-seeking bureaucrats. And I don't care whether it's a rent-seeking bureaucrat in Boston or Botswana. The first issue is that the tax input credit refund system on exporters is the major weakness of a value-added tax system. It's the most common source of fraud, because

what happens is that everybody has an incentive here. If you blow up the amount of exports, the politicians love it. I mean the exports are growing at 50 percent a month, and that allows exporters then to run the printing press on their invoices for their inputs, and claim a refund. It's as simple as that. It's printing money. If you can get customs to add zeroes to the amount of exports you claim to have shipped out, then you can add zeroes to what you have paid as input taxes, and eligible for refunds.

The problem is that the real exporters are the ones who have a lot of money outstanding. Most firms that are in the business of exporting are not in the business of fraud. But the problem is that there are people who call themselves exporters who are not exporting, but are in the business of fraud. So how do you separate the two? The first thing is that the people who have really a lot of money on the line are the people in the business. They've been paying 10 percent on all of their inputs, and the bureaucrats are sitting there saying, "Well, I don't know whether this is the right number. Maybe, General Motors, you're committing fraud." So what do you do?

Usually it means the honest exporter starts paying facilitation fees to speed up the process of refunding. Once corruption starts, then these same bureaucrats have no problem adding zeroes to some local mafioso who calls himself an exporter. By the way, they're not all mafiosos. Actually the head of the Chamber of Commerce in Bolivia got away with \$6 million this way not too long ago. It's estimated that in various other countries, it's easy to get \$10 to \$20 million this way. So corruption of this magnitude is a problem.

Another problem that arises with the VAT is that some countries treat the refunds as a government expenditure and not as a net to VAT revenue. So that means that these VAT refunds to exporters get tied up in the same bureaucracy and the same IMF conditions that control cash-based budgeting or filling the pot holes. Again, it's very hard for the legitimate exporter who's piling up these refunds not to start paying tips.

What are some of the solutions? The big job is how to separate the exporter who's in the business of exporting from the so-called exporters in the business of fraud, because both are paying tips. One way to do it is to say, "You go and buy yourself a government bond, an interest-bearing government bond, Mr. Exporter. And we'll give you your refund right away. That'll give us a couple years (or six months or whatever) to check out whether or not this is a legitimate refund."

Most people that are in the business of fraud don't like buying government bonds, whether they're interest-bearing or not. They're not about to sit there for six months holding a government bond, which the government can claim at any moment, while they're waiting for the clock to run out so that the bureaucrat will suggest that everything's OK. Usually folks that are in the business of fraud are very allergic to buying government bonds as an offset to getting the credit fast, or buying a guarantee or a bank guarantee. The people who want fraud want transactions to happen fast, be finished, and maybe get out of the country. But the legitimate exporter finds that buying a government bond is a worthwhile thing to do if he's getting interest. He may even be able to borrow against the bond. Or, at least over time, he can establish a track record. In exchange for a guarantee, the legitimate exporter gets his money fast. Therefore, there's no need to pay tips.

Another solution is what they did in Kenya. They bonded the auditors and said, "If you get a certified auditor to audit and say that this is a legitimate refund, then we'll pay it immediately." Then there's no reason to pay tips. It's clear: If you have an audit statement, you should get your refund. I think Graham Glenday (CAER II Discussion Paper 74) said that 40-some percent of all claims for refunds disappear. Again, the folks who are in the business of fraud don't like going up to Price Waterhouse. They don't want to get too well acquainted with the Price Waterhouses or the Lloyds of this world.

Another way is, in fact, not to levy value added tax on the imported inputs. When you import goods, do not levy tax if these inputs are going to a legitimate exporter. This makes a lot of value added tax people nervous because it breaks the value added tax chain system, but "necessity is the mother of invention." Taiwan has done that and Singapore and Indonesia have done it to a fairly large extent. Again, the people in the business of exporting prefer to stay a mile away from fraud unless they have to, unless they are corrupt.

If you really can't get the credits out the door, then don't pay credits but pay it in terms of tax certificates, which the firm can use as a credit against either Social Security tax or wage withholding. That helps, in fact, to keep the withholding up on wages and Social Security. In some countries, of course, that could pose a problem because the firm has been paying Social Security tax anyway; or rather, they wouldn't get any workers if they had to pay Social Security tax. If you look at a lot of countries in former Soviet Union, the Social Security tax is almost a prohibitive tax. But I'm saying for most normal countries, normal Latin American countries or an African country where wage withholding is quite important, then the exporter will tend to have more wage withholding liabilities than he is going to get credit back from the export tax credit.

The second question is: How do you get your imported inputs duty free? The first system that's often mentioned is duty drawback. That's basically what I call an incubator for corruption. The problem with a duty drawback system is that the only body that has any information is the exporter. When the goods came in, nobody said, "This is for export." It was just normal inputs and they paid duty. Then the exporter decides that he's going to export, and therefore, he's going to make a claim for duties that he's supposed to have paid. Most customs don't have records worth a hoot. Therefore, the duty drawback team starts negotiations. The negotiations start with the exporter. Everybody is suspecting everybody else and usually facilitation payments have to get paid in order to get the drawback paid.

There are actually three ways of getting this credit back. One is you do the calculations after export based on negotiation. The second way is using the export processing zone whereby you build a fence around it. You have to keep in mind that EPZs are an expensive solution. They are useful when a country is characterized by a poor industrial infrastructure and excessive bureaucratic rent seeking, but also has an abundant, well-educated labor force. I mean, look at Sri Lanka and the Dominican Republic. Usually, the EPZs have to pay off a compliant customs and have their customs guys on the payroll. That's the reason they let the goods come in and out without a lot of harassment. Sometimes you even find a transportation mafioso gets built up to move the goods in and out from the port to the EPZ.

So I would argue that it's very important to have a competition among private EPZs. The competition introduces an incentive to try to break down the rent seeking that's adding to everybody's cost. I might add that in Indonesia, there were virtually no EPZs during the initial phase of the boom in export manufacturing. It's only when rent seeking got back into business that people ran into the EPZs for shelter. With EPZs, goods tend to leak out of the EPZs for sale on a local market because it's difficult to levy heavy sanctions against foreign ownership of factories, and it's very difficult to know which factory the goods come out of. Basically, it's the responsibility of customs on EPZs to make sure domestic sales are not made without paying duties. I would argue that for most countries, the EPZs are an idea whose time has passed, and even for Taiwan, EPZs never counted for more than 9 percent of total exports.

The last interesting issue is why bonded factories, bonded warehouses and duty-free factories have worked reasonably well. First, the one administrative thing common to all these is that as a duty exemption scheme, where the import duties are held in suspense as a liability and then cancelled upon export, it's an accounts offset system where the liability is recorded when imports enter the country. Transparency is very important even among thieves. When the goods enter the market, it's identified that this is going for export and going to come out and you have a little PC that records it. And if you add a bond or a guarantee that the exporter puts up a bond, then the real exporter has no incentive to cheat by sending things out through the back door. The fraudulent guy is very allergic to bonds and guarantees. You have a somewhat automatic policing system with a duty exemption. That is, if you have an exporter that starts to leak duty-free inputs out the back door, the competitors in that input market will be screaming before sunset. The market provides its own watchdogs. The main sanction is to lift the license of the person who has the bonded warehouse, which is a draconian penalty that essentially puts the guy out of business. No exporter who's really an exporter is going to mess around with that. He's not going to mess around with the stupidity of his competitors or the lack of creativity of other penalties. I'm saying there's no real surprise why the duty exemption system has worked because the dynamics are to keep it working in the way it's meant to. The other methods tend to have elements in it whereby somebody makes money by breaking the rules.

**Presenter #1: Steven Radelet (response to Glenn Jenkins' remarks)**

I agree with almost everything my colleague and former teacher said, especially on the advantages of duty exemptions and on bonded warehouses as really important facilities. The one comment that I would quite strongly disagree with is the impression that EPZs are an idea whose time has passed. It's true they are not the primary facility in most countries and they weren't in Taiwan, but this statement would be news to the Dominican Republic where it's 100 percent of exports, so obviously its time has not passed there. Or in Mauritius, where EPZs account for 95 percent of all exports. Or in Malaysia where after 25 years, they account for 55 percent of all manufactured exports. Or in the Philippines where they account for all of the electronics exports and the list goes on. That is not to say they are the best facility always. They're not, but again, I would argue quite strongly that the option should be available and that in most countries under the conditions that Glenn outlined, where the infrastructure is quite poor and the bureaucracy is quite strong, that this is the best option. So, maybe we don't disagree, except I don't quite like the statement where it's an idea whose time has passed.

## ANNEX: QUESTION AND ANSWER PERIOD

*The conference web site includes a list of all participants and their institutional affiliation.*

DANIEL TORIBIO-MARMOLEJOS: I would like to make a comment regarding some of the innovative solutions that were presented. Basically, regarding exoneration of or the non-payment of customs duties when we know that we are going to export goods. Basically, that does not take care of the problem because there still could be communications. Who is going to tell you that the exports are legitimate? What is going to happen with one exporter who also is producing for the domestic market? I think that at least the idea of duty-free or tax free regarding custom taxes stimulates corruption as much as imposing taxes. Or getting the taxes back after an operation or give them credit for the payment of other taxes, for instance, different custom taxes. Because one thing is who authorize the restitution of taxes by the competitive organization as a credit for the custom taxes. And on the other hand, would be totally different if the customs, per se, would authorize the restitution of those monies. We are applying right now the system of getting credit, the internal administration for the taxes, only when the custom is giving the money back but who is monitoring, who is taking care and watching these organizations? That's all I have to say, thank you very much.

STRYKER: I'm Dirck Stryker from AIRD. I have two very specific questions. One for Lynn, whose presentation I thought was very interesting. Your recommendation that the preferences be granted uniquely to African countries, the question is, is this in violation of WTO? Is this not a reversion to the dispute that we've had with the Europeans over their particular preferential treatment of the ACP countries within the Lome convention? In particular, the recent banana dispute, in which they've argued essentially that they're trying to provide benefits for countries. We argued that this needs to be done on a multilateral basis rather than pick out a particular group of countries. The second question is for Glenn Jenkins. I found this very interesting discussion of the problems of exempting taxes on inputs that are used in the production of exports. The question that I have is, do you have any experience with the possibility of using a central and negotiable instrument as a tax credit? I think your notion that tax credits can be given which then could be used for payment of income taxes or for social security is interesting. But often these taxes are collected by different administrations than the customs duty and the indirect taxes, the VAT. If you issued a tax credit in negotiables so it could be sold on a secondary market, then it could clearly be exchanged so that those people who could make use of the tax credit could purchase and use it to pay customs or whoever the indirect tax authority is. I just wondered whether you have any experience with that? It seems to me that it shouldn't be any more difficult to prevent fraud in that case than in the case of providing tax credits that would be used with income tax, etc. Thank you.

JENKINS: OK, let me deal with that one first, and I'll come back to the Minister. On the negotiable instrument, it works in Uruguay because they have a strong auditing capability. If that's going to work, then you have to say that the person who uses the certificate is the one that's liable to insure that it's a legitimate certificate. The printing presses will run wild. Don't worry. It works in Uruguay because you have very strong auditing of the major companies. But I would never touch it in most other countries because of "running the printing press" and because you just don't have the auditing capability to know whether this certificate that was for somebody else's excess credits is worth anything at all. The reason why I'm saying use the tax credits for

another tax is because you're making sure that the person who is the exporter is, in fact, in business and has withholding that is required. So, the legitimate exporter will be quite happy. Now, there may be some excess credits. I don't have too much of a problem of starting a refund system on the excess credits. But that narrows the problem dramatically and narrows the incentives. I think most exporters, if the bureaucracy gives them too hard a time, will walk away from the excess credits.

Do you want me to deal with the other issue the Minister raised? If I understand the question correctly, it is that if you allow people to bring goods duty-free into the domestic part of the continent, then what is going to stop that going out the back door and being sold in the rest of the economy without paying tax? This is why I would argue that it's very important to have a set of government bonds, bank guarantees. When that stuff comes in, it's reported how much tax should be paid, and the person who says that he or she is an exporter puts up a bond or a guarantee equal to that amount of money. So then if it goes out the door, you have to have very simple auditing techniques to ask the question, how much inventory are in the warehouse? If he hasn't shipped enough out through customs, then you have the government guarantee. Now, it is true that you may have a very loose customs, which you have in the Dominican Republic, and those guys will add zeroes onto the exporter's numbers of what they're exporting. Now, the issue is will a legitimate exporter-- who's making shoes and who has gone to the bank and gotten a guarantee--take the risk of bribing customs, shipping his goods out the back door duty-free, and getting all the competitors howling while he's sitting there having paid for a bank guarantee that anybody from the Ministry of Finance can go to the bank and get paid? So, my sense is that few businessmen have the inclination or the nerve or the time to waste on that kind of a fraudulent deal if you have made them ahead of time. Either by a government bond, which you can cash, or a bank guarantee. You see, most people then say, forget it. It's not worth it. Now, if you have no guarantee and the people are well-connected, then they may be able to sell a little out the back door. Especially if it's the army that owns the business. But the thing is that generally most legitimate business stay away from this like the plague.

SALINGER: Let me just briefly respond to Dirck's question. The notion that preferential market access should be extended to other more vulnerable trading partners obviously comes from the US experience with NAFTA. Look at the tremendous shift in source of supply that we've had with respect to clothing imports, for example, coming in from Mexico now as opposed to traditional Far Eastern suppliers. But, of course, that's a reciprocal trading agreement amongst the three partners, and you're absolutely right in pointing out that unilateral granting of preferences to the African countries would probably not hold water under WTO regulations and that some kind of a reciprocal arrangement would have to be negotiated. This is the current challenge that the European Union is facing as it renegotiates its Lome IV agreement with African, Caribbean, and Pacific countries.

MEALEY: Yes, I'm Marc Mealy, I'm with the Committee on International Relations on the House side. I wanted to raise two questions or two comments. One, as an economist and then one as a staff member, I guess, sort of in the policy bureaucracy. First, as an economist, I share a lot of the perspectives that both Lynn and Steve offered. I think some of our own work has kind of dovetailed some of my previous work in using Stace Lindsey's work and Michael Fairbank's work and Michael Porter's work around comparative factor advantages. One of the conclusions

that I've kind of been wrestling with is kind of as follows, though. In this current era of globalization a number of sectors--and textiles, I think, is a good example--have really become the more globalized industries in the world. As a buyer-driven commodity train value, profitability, and levels of competition are really driven and captured by, as you said, the retail side. We know that's really where much of the profitability is generally located in these industries right now. If we take that as accurate, then what is the benefit of looking at the history of the successful export development strategies which have generated stronger benefits for growth historically as necessarily a good indication of whether a similar strategy in textiles would generate similar or perhaps lesser benefits in the current environment? I think that's one of the things I've been kind of wrestling with. Because historically we always have the sense that textiles was the engines for growth in so many societies around the world. But that was 50 to 60 years ago and the textile industry is not the same global industry now that it was 60 years ago in the sense where value really gets captured in that industry.

The second point, again putting my member of the House Committee on International Relations hat on, is Lynn's extremely critical point that the need for reform in the trade policy regimes of developed countries. Because you can imagine a scenario where a developing country, doing all the right things, investing time and resources in really getting a good successful export strategy going, and finding good success penetrating markets, getting good sales one year, two year, three year. What happens in the third year? Potentially a domestic industry files a countervailing duty suit or an anti-dumping suit, which would probably blow them literally right out of the market. For our current administration, as many of you all know, competition policy is not on the table with regard to the WTO because we know that politically that means perhaps changing US anti-dumping laws and US countervailing duty laws. It's in that political realm that I think we, in some of our research perhaps, really need to address. It does have to be the coherence, I think we're talking about, in policies if these successful strategies over time are really going to be sustainable and have positive impacts for the long-term growth of any developing country. Again, I really stress that this really is an area on which a lot of work needs to be done. Thank you.

PARTICIPANT: Hi, just a very quick comment on the question about the negotiable tax certificate. There's an interesting article from way back in the 1960s by Richard Porter called "Birth of a Bill Market in Columbia," and it had exactly that system. The main point of the article was how in those days people didn't believe you could have a private money markets. The point of the Porter article was how easy it was for these things not to *be created*, but to *create themselves*, of course. The other point was that since they were only good for payment of taxes, they were very easy to police because you had a holder in due course kind of situation. It worked very nicely even in Columbia.

RADELET: Let me just say this is Lisa Cook, who I owe a debt for writing two of the background papers for the EPZ study, nice papers on both Tunisia and Ghana. So, she's quite relevant to these studies.

COOK: Thank you, Steve. So, I don't need to identify myself. I still have two persistent concerns concerning our own research. I thought I might ask it to a larger audience. If we take a look at your Table 1 again, Steve, there's a lot of variation among these countries in terms of

export growth and average growth per capita. The first question is, what are our projections for the next 27 years? Can we delineate, can we distinguish between the best performers in the sample, export growth-wise, and the worst performers, and say something about the adoption of education policies? I noticed that in the three countries that I studied, Tunisia, Ghana, and Egypt, Tunisia's the only one really prepared to follow this flying geese model of going from textiles and apparel to electronics and higher value added products. The second concern was that I saw these enclave environments not at all deriving or exhibiting spillovers into the rest of the economy technology wise and labor wise. I really wonder if in the poorer performing countries, Egypt and Ghana for instance, relative to Tunisia, how this can sustain itself going forward? Because in these other countries, for example, there may have been EPZ-like or EPZ benefits extended to firms in the domestic economy. In Egypt and in Ghana, for example, there aren't and you see penalties being imposed on firms in EPZs to use domestic suppliers rather than extending those privileges to them. I think that there are two persistent concerns that I just wanted to raise in this forum.

RADELET: Next time you have to ask me this question in private session [LAUGHTER] before we get to the comments. We've only been working on this for a year, Lisa. No, actually, it's a good question and it's partially related to the earlier question. There's always a danger in looking at history to think about the future. As people say, akin to driving down the road by looking in the rear view mirror, and if the road was straight behind me, I assume that the road is straight in front of me. But obviously that's not always the way it is. The issues here are changes in the global environment that were raised earlier. Lisa's questions are related to that. Then making the jump from textiles to higher technology kinds of exports and the connections to the rest of the economy. The textile industry is different than it was 50 or 60 years ago in many ways. In some ways, it's similar but there are a lot of differences. First, you don't have to go back 50 or 60 years. Many of these countries, it's actually in the last 10, 15, 20 years. Some of the changes are beneficial, some of them make things more difficult. The beneficial part in the globalized production networks is that firms can become much more specialized than they could have 10, 20 years ago. That's an advantage. That they can really specialize in one particular thing, do it really well and sell to a huge market. They don't have to be quite as vertically integrated as they used to.

The retail sales issue that you raised, I think is a relevant one for the high-end goods. It's not so much an issue for the stuff that's sold at Wal-Marts and things like that, where the advertising budgets are not quite as huge. Although that's added a lot to the ultimate retail sales, from what I can tell, it hasn't changed much in terms of the economics of the production itself. It certainly adds a lot to the cost, but it's topping up on top of the retail. I don't think that that in and of itself leads us to believe that this is gonna be less successful. The countries that are still doing it in the '90s, we still see wages going up. Real wages going up in textile industries in most of the countries that are doing it. So, I think it's a possible danger, but I don't see any evidence of that kicking in yet. But the world is changing, and just because it was textiles 20 or 30 years ago, and then electronics more recently, I don't know what the magic good is going to be in the next 20 years. It could be some sort of IT. We see a lot of firms that are beginning to do services over the Internet, doing back room accounting services and things like that. We met with a firm a few months ago that does work in India that basically does the medical charts for hospitals in Chicago. Where the hospital sends the stuff overnight to India, the data is entered in India, and

sent back overnight to the hospital in Chicago so the doctors can have their charts the next day. It's actually mind-boggling. The mix of industries is going to change. I think most of the main ingredients in terms of getting the infrastructure and the macro-stability are going to stay where they are.

One of the big challenges in addressing Lisa's stuff, one of the big challenges is to continue to move ahead and to think ahead and to look for opportunities four, five, six years in advance. Where your comparative advantage changes because skills change and wages change, and everything else. You've got to begin to lay the foundation to move into new industries. A lot of countries have difficulty with this. The jump from textiles to electronics is a very difficult one and it takes a recognition that comparative advantage is not stagnant; you need to change. It means building new education skills, improving the skills of the workforce, getting the infrastructure in place, getting the telecommunications facilities in place and a whole range of other things so that it is not an automatic move up the ladder. And often this has the impression that once you're sort of on this ladder you're going to automatically move up, and it's not. And I think Singapore's the best example of this where they've been quite aggressive at every step of the way at thinking where the next step is going to be. So you don't get outside of your comparative advantage too far but you're always pushing to the next part of comparative advantage.

And your last question on the connections to the rest of the economy is related to the issue that I raised earlier. It is a problem in many places that the technology and techniques don't spread to the rest of the economy and the domestic suppliers don't always sell to the exporters. The rules and regulations of forcing exporters to do that are doomed to fail; they won't work because all they do is raise costs. There are reasons why the exporters aren't buying the domestic goods and you've got to address those reasons directly. It means that the domestic firms are high cost, low quality, generally because they themselves have to deal with high import tariffs, lousy infrastructure, lousy telecommunications, those kinds of things, and until you deal with those things you're never going to get the low-cost domestic suppliers and therefore the transfer of technology to the rest of the firms. So the point is that these are dynamic and again the enclave, whatever it is, has to spread over time. If it remains as one separate piece without a strategy to get this to develop further it's not going to work. It has to be a dynamic process where it begins to spread and you're continually dealing with those problems that affect the rest of the economy.

SALINGER: Let me respond to some of the good comments and questions we got from Mark by telling a story. In other work that I'm doing, also organized through the CAER project, I should note, in Mali, I'm grappling with some of those questions you were asking about what's the future of a labor-intensive, export-oriented manufacturing sector. We're looking at textiles and clothing in Mali and we're looking at it from the perspective of these insights that we've freshly drawn from this work of how to attract foreign direct investment into the industry. Mali is a world exporter of the basic raw material of cotton fiber; why can it not move into value-added processing? And as you do some exploration with industrialists brought in from the outside you see that, not only are there the myriad of the usual infrastructure problems in a low-income developing country that would confound many investors coming into the country, but you see that this emphasis on the low value T-shirt model, to be general about it, isn't offering much hope for Mali. Mali, which has two, really just one, struggling clothing manufacturer

currently, cannot hope to compete with a Bangladesh, for example, in producing enough T-shirts, high enough volume, low enough cost, to compete on world markets. Foreign investors are not coming into Mali to take advantage of their low-cost labor.

So what's the future for a place like Mali? Well, it turns out, if you broaden your vision beyond the formal sector and start looking at some of the informal sector activities going on in the country, Malians have a rich tradition of working in textiles and clothing. They produce fabulously-tailored and embroidered garments which, if you start thinking about high-quality, upscale market niches, might attract an interesting market in South Africa, in our own country here, serving the Afro-centric garments market, if you will. You talk about retailer concentration confounding how that penetration is to occur. Well, leap-frogging is spoken of in many circles these days. Might it not be possible through the Internet, through catalog retailing, to try and circumvent some of the traditional retailing powerhouses in our markets. These are some of the questions that we're dealing with in the context of a country which doesn't want to just do the same old thing that got Bangladesh on the road ten or 15 years ago and is looking for new and interesting ways of using their core, traditional competencies to break into the international market.

FAJARDO-CHRISTEN: Adrian Fajardo-Christen from USAID, Peru. Steve made a point that the support platforms are temporary, although for the long haul. So the question I have for him will be if there has been any country that has graduated from its support platform, and if so, you know, what were the turning points? And then I have one question for Lynn Salinger. I think it's a good point to bring this coherence in internal market reforms in developing countries. I mean, given that we are talking about development assistance, paraphrasing Mark Malloch Brown [UNDP Administrator] last night, it will be, you know, the power of internal reforms that opens up the developing country's market, and will be mightier than their pockets in terms of development assistance. So my question goes into, how do you think we should go about getting these internal reforms? I imagine we'll be lobbying Congress but maybe you have other ideas.

RADELET: In terms of graduation, the ones that are closest are, not surprisingly, the ones where it started: Hong Kong, Singapore, Taiwan, Korea. Hong Kong and Singapore are basically export processing zones in and of themselves, especially Hong Kong. Singapore uses fewer facilities than it once did and so is nearly graduated, basically because, if you will, the enclave has spread to the whole city-state where tariffs are low and FDI is welcome and infrastructure is fine, and so they don't really need the separate parks quite as much. Glenn pointed out that in Taiwan it's declined and the use is declining of EPZs; 9 percent is the peak. It's even less now. Korea the same way because more and more firms are able to compete without the facilities because the infrastructure's now good and tariffs rates are low and they don't have to use the particular facilities. Then you see it for kind of the second tier as well. Malaysia at one point, 75 percent of their exports went through EPZs. Now it's 55 percent, still a high number but coming down. As Glenn pointed out, more of them are moving to bonded warehouses because they don't need the infrastructure of zones. So over time it sort of goes away from the zones to just the bonded warehouses to the duty exemption systems, and then as the duties get lowered they move on. So total graduates, no, except Hong Kong and Singapore which are kind of special cases.

SALINGER: Regarding how to advance internal reforms, Congress is one way. Making sure they have copies of your reports and talking to them is one way of influencing the dialogue. Ambassador Babbitt yesterday called for increased efforts by researchers and the rest of us in the development professional community to interact with policy-makers. Another interesting approach that is being supported by the Agency for International Development is to work via international organizations to pass the message back down to our own government. If you can't get your boss down the hall to listen to you, maybe your boss down the hall will listen when it's coming from across the ocean. As Richard Carey mentioned yesterday, there are people in Paris at the OECD within the Development Assistance Committee, for example, who are also working very hard on these issues, and the G8 last spring raised a lot of these issues. I think what is important is that there are increasing numbers of voices talking about this and hopefully raising visibility on the need for a coherent policy framework. It's not a terribly satisfying answer because it requires a lot of work on all our parts.

JENKINS: There are two kinds of things that I want to tie together. One is the EPZ comment, and the other one is this idea of how do you make this a more natural sort of operation. Taiwan did an interesting thing, and a few other countries have done the same, they've introduced the duty exemption system. But when a domestic manufacturer sold into the local market, they only paid the duty on the imports. For most export processing zones, manufacturers paid output duties, not input duties, right? When you sell from an export processing zone to domestic, you pay output duty, which is usually 100 percent. The Dominican Republic was something like 75 percent on shirts. Your local poor person in the village, who had to pay 75 percent more than they paid in Orlando for a shirt. Yet, you were exporting shirts next door. Now, the thing is, if you do the Taiwan operation, and you allow your domestic firms to export, but sell in the local market only at the import duty, then that means if there's any competition, you have two or three shirt manufacturers, then you bid the consumer price down to the world price or even below it. So, you really get some efficiencies coming out of the zones into your domestic economy. I think it's that, and if you ask how you get policy changes in developing countries, you get them changed by having local entrepreneurs. Those are the folks who vote with their money and vote with their relatives. And the problem is that the zone, with this walled fence around, if a foreigner wants to come in and wants to go out...the reason for that zone is so he doesn't have to touch the locals except for his workers, so he doesn't have to touch the local business. There aren't the political dynamics to bring the locals around to cut out the rent seekers, which is running on the high tariffs, and you got to get some local politics to cut out the rent seeking. I think that Taiwan did a very neat trick, and a few other countries have done the same.

HAVRYLYSHYN: Thank you, Oleh Havrylyshyn, from the IMF. I'd like to compliment the entire panel for a very nice set of papers, which put together give the wonderful tour de raison of these various issues. Steve Radelet's paper, I think, very nicely puts the role of special kinds of government institutions in a nice context that you have to get the other things right, as it were. For the sake of argument, however, I'd like to suggest that you may have gone a little bit too far in promoting the role of government. Less in your paper, I think, and more in what you said this morning when you said that it's not enough to get the prices right and the macro right, and that there are no cases of successful exporters that haven't also undertaken some kind of government promoted institutions, such as EPZs, etc. Let me, for the sake of argument, take issue with that.

First: methodologically. It's not clear what your counter-factual is here. Do we actually have cases of countries that have done everything right in the macro and micro, but have insistently refused to do EPZ type of stuff, and have, therefore, failed? That may be a null set and, therefore, you want to be a little bit careful in the hypothesis testing of drawing that strong a conclusion. Secondly, the coincidence of having EPZs, along with the others for the successful exporters, is quite obviously, logically not evidence for causation. Then third: empirical. In fact, I think there may be some cases of successful exporters who have not used this sort of thing. Marek Dabrowski may tell us a little bit about whether Poland fits into this. But Latvia certainly does. I could be unfair and talk about Estonia, but Estonia is successful without having this model because the whole damn country is an EPZ, but I won't use Estonia, let me use Latvia. Its export successes started before internal domestic politics on getting lower taxes for self-interest groups led to the establishment of tax-free zones, which are not EPZs, as such and have not really contributed to exports but there was nothing that they did. Finally, let me say that you have defined government promotion or government institutions to help along the export process quite widely. If you include tax-related systems, duty drawbacks or bonded warehouses, well, that's not promotion or government intervention in the market. A bonded warehouse is equivalent to the escrow type notion that exists between employer and employee when the employer reports through the tax authorities what you have earned, withholds a certain amount of taxes. Where you have the right to claim exemptions and, in effect, at the end of the year, you have to prove that you have claimed those exemptions. That's no different. That's just tax administration and tax policy.

HAUGHTON: Jonathan Haughton, Suffolk University and HIID. Just, since it's very much in the same vein, there seem to be two pieces missing in what I hear on EPZs. One is, one would like more of a cost/benefit analysis here and we haven't heard much about the costs. Vietnam has spent a lot of money on EPZs and related-type zones, one of which is probably successful by any standards, the rest of which are failing. And whether that was good as a general policy is by no means yet clear. And the second, in a sense, question I would raise is, if a country goes down the route of developing EPZs, does that speed up or slow down the pressure on more widespread trade policy reform? And that's an empirical question as you can make arguments either way. But I don't hear a compelling case that if you build EPZs they inevitably lead to the Promised Land. India had EPZs for how many years before the real changes came and they were absolutely nothing to do with EPZs.

RADELET: Lots of questions on EPZs and as I said when I started, I intentionally want to talk much more broadly than EPZs because if we focus on EPZs we're led into these traps, because they don't work in all countries and that's exactly the point as to why you have to have more than one facility. And if you think of this in terms of, well, Country A has EPZs and it didn't work, or this country has worked without EPZs, then you've missed the point. You've got to have more than one facility. Lots of countries have been successful without EPZs but they've had duty drawback systems or bonded warehouses. Now, I don't know the case of Latvia but I can't imagine how exports could be competitive unless either their tariffs are very low to begin with or unless there's a duty exemption system. Then they fit the pattern; then, exactly, they're not an exception; they're consistent with the rule. And as Glenn pointed out, EPZs were not a major part in Indonesia and in Taiwan they were 9 percent or something of exports. So if we focus just

on EPZs we miss it by big, wide margin. It's the broader sense of export facilities and giving exporters the choice as to what is the best kind of facility for their production.

Now, counter-factual. Are there other countries that have done everything right? No, that's the point. If you did everything right that would supercede the need for these. The whole reason for these is because it is too difficult to get the infrastructure right this month. It takes years just to build the infrastructure. The political economy of trade reform is that it takes years, realistically, to get the tariffs down on a wide range of imports. Same with foreign direct investment, and that's the point, that because it is too difficult to get everything right that you need these facilities, and if you can get everything right, fine. It's the point that these are kind of temporary until you can get these things right. So again, the empirical issue that you raise is still there because there isn't a clean counter-factual. But I do come back to the fact that if we look at all the countries that have been successful, one of these facilities or more has been at the heart of the system. Glenn points out that 9 percent of Taiwan's exports went through EPZs but if you count the exports that went through duty exemption systems, draw-back systems or bonded warehouses and EPZs you've got 100 percent. You've got them all. So they all go through all these systems and I think that's been the case. Causation back and forth, of course very hard to do it, but again, I come back to, I don't see any countries that have done it without it. They've got to have these facilities in place first; the export boom comes after. And again, it's not just EPZs; it's the other facilities as well that you've got to get these going out.

I probably did overstep a little bit in terms of government interventions to be a little bit provocative and it is a little bit milder in the paper, but the point is that these are not just markets, that governments have to take some decisions and have these strategies in place. And even in bonded warehouses it's consistent with what is in tax legislation. Governments have to think about this and put the legislation in place and put the system in place to allow this to happen. It's not just these things are going to spring up just from the market. That's my only point, is that it has to be part of a strategy. Promote is not the best word; facilitate is the word that I like to use when I'm being a little bit more careful rather than promote, because we're not picking winners here. I'm not at all into picking winners at all. Cost and benefits and then I'll shut up because I'm going on and on, but I have lots of questions to deal with here. Again, there are lots of places where it's unsuccessful and they've built zones that haven't made any sense; they're poorly managed and have not reached any benefits at all. So, as I say, they have not always worked. You've got to have the conditions right. If you don't get the conditions right you're going to throw the money away. You're going to waste the money. Glenn points out that these EPZs, as one facility, are expensive because they're trying to overcome the other expenses of infrastructure development. Most of the studies that I've seen on cost and benefits give the nod to benefits. These studies are static; they don't take in technology transfer and other kinds of things, but they'll give a slight nod of the benefits being slightly higher than the costs. Peter Ward did a series of studies and several others. But it's a small margin, but then they're static studies rather than dynamic.

SALINGER: I think it's just worth noting that we did ask US electronics and apparel firms whether having an EPZ in a country affected their decision about where to operate, and in certain instances were told that no, in fact, companies were shying away from EPZs, that they threw up lots of road blocks, raised costs, made certain, shall we say, informal regulations come to the fore

that made it difficult for them to operate and it was actually easier to operate outside. Because, Lisa, you're here, I don't mean to put you on the spot, but there's a lot of richness to your study that I don't think we've harvested and as we talk about costs and benefits it would be nice to hear from your experience in Egypt or in Ghana about what causes certain systems to not work effectively. Could we hear about some of the problems that keep Ghana from being one of the world's leading exporters, for example?

COOK: In Ghana I think it was pretty straightforward. There was cheap labor but you got what you paid for and there were apparently electronics firms in Ghana before the liberalization and before the institution of EPZs, but you don't have anything that looks like an electronics firm coming to Ghana to produce. There were labor disputes as well and the labor disputes weren't sort of the typical labor disputes. The disputes were among competing labor unions, which scared investors away, including the largest textile producer in Ghana. So I think that's the essence of Ghana's problem, but between Ghana and Egypt, the big problem was penalizing firms that were in EPZs by imposing restrictions, labor and other restrictions, input restrictions, on them concerning domestic suppliers. The proper thing to do was just to extend those benefits, move the enclave further and further, rather than bat them over the head. So I think that those were clear. There were other sort of common elements, but not as stark as those.

CROSSWELL: Mike Crosswell, USAID. Somewhat in the spirit of the past several questions and focusing on labor and work force, Lynn, you put quite a bit of emphasis, I thought, on work force development. I'm curious whether that is mainly forward-looking or whether that's played a major role in past export success and if so, what does best practice look like in the area of work force development?

SALINGER: It's absolutely forward-looking. I think if companies are going to get out of the trap of low-value-added, low-wage-cost industries, they're going to need to develop their work forces to the point where they can be as innovative and creative as others around the world. Best practices, from this work I can't say that was the point of the research, but in previous work in South Africa, one of the very interesting things we saw was a few modest experiments being done by different managers in terms of promoting this multi-skilling of labor forces. In other words, there's a lot of learning on the job that happens in companies. Companies that traditionally organize their firms hierarchically and assume that workers cannot be sources of innovation are probably companies that are doomed not to compete successfully five or ten years down the road when their markets are completely opened. So I think my emphasis on work force development has come out of seeing these experiments going on and realizing that management training to enable and facilitate those experiments is as important as worker training.

CROSSWELL: This sounds like this goes on in firms. So the question is, what are the implications for the donors in the public sector?

SALINGER: I think there are partnerships that need to be put together between the private and the public sectors and to bring in educators and trainers as well. There's a large human capacity development industry out there and the point is to make the learning opportunities as applied as possible to worker and employer needs. I think too much emphasis in education funding has

been on primary education and while important, and while that in part produces workplace-ready adults, there's a lot of on-the-job kind of focus that needs to happen.

KOROPECKY: My name is Orest Koropecy. The question I have just kind of grows out of curiosity listening to all of this. Does anyone know what the antecedents of these enclaves and export platforms are? I'm thinking specifically, does this go back to, for example, the colonial era where you had these spheres of influence and you had the, like Shanghai and this sort of thing, and I just, if either any one or all of you know something about this, I'm just curious to know.

RADELET: That's looking pretty far back. The short answer is, I don't know beyond the history of, I think it was Kau Shing which was the first in Taiwan, and Ireland at the same time had early ones in the late '50s, early '60s. But I must confess I haven't done a study of colonial history of EPZs. No, I shouldn't be so flip. It's actually an excellent question but most of the stuff that I've read attributes Taiwan and/or Ireland to having the first in the late '50s, early '60s, of zones. Now, for other facilitation things like duty exemptions, I don't know the longer history. Do you, Glenn?

JENKINS: No.

COOK: Orest, actually, Tunisia was the biggest EPZ in the Roman Empire. [LAUGHTER]

MADHUMITA GUPTA: I just have a Delhi observation. In 1982, India introduced the 100 percent export-oriented units. These were bonded warehouses and what we saw from that experience is, unless simultaneously the domestic market also makes the effort to open it up slowly and to start the liberalization process, these bonded warehouses, so-called exporters come in and their target is really the domestic market. They came in; they said we needed 5 percent rejection to sell in the domestic market to make ourselves viable, and because the domestic market was so strict, it was so restricted as far as liberalization was concerned with regard to exports, you know, we had something like 18 different import license schemes in play. Finally, slowly, the exporters said, well, now we need 25 percent sale in the domestic market to make us viable. So the EPZs only worked, as you said, in the short term if you're simultaneously also trying to open up the domestic system to make it more globally competitive. Otherwise it didn't work in India.

NORTH: Thank you very much. Walter North, USAID Zambia. I just want to pick up on the comments about education and the implications for development investments and trying to look forward to think about how countries in sub-Saharan Africa can tap into this, if at all, given the basic break-down in almost all social institutions. The declining levels of investment in every level of education and basically the end of tertiary education as an effective instrument, and what kind of strategies you would recommend for donors in that kind of a setting. Plus, of course, in the case of a country like Zambia you have the overlay of investing in education, populations that are going to be highly impacted by HIV-AIDS.

RADELET: Let me take one part of that and I think Glenn probably will have to say some things as well. Not specifically on the education, but this, the export strategy, I'm not sure if it's

the solution for all countries. It hasn't worked for landlocked countries, essentially; for Zambia, for Rwanda, Burundi, Bolivia, Mongolia, Nepal, because, essentially, just from the straight economics point of view, the transport costs are too high and they overcome whatever wage differential there might be and it's just very difficult. The idea of an export processing zone in Zambia is a little bit different, obviously, than one on the coast in Kenya. One of the key things about EPZs, whether they work or not, one of the other issues that hasn't come up is location, location, location. And that's important. Within a country, you can't build one of these things way out away from all the good infrastructure, but it's also important in terms of location of countries. Zimbabwe is the only country that I know landlocked that has had some success in exporting textiles. So landlocked countries have a particular problem. That can partially be overcome by certain exports that can be airlifted out: horticulture. It can be partially overcome through IT. If you've got a good English-speaking population like some of the interior parts of India, for example, where you can overcome this, you can overcome the transport costs with certain things. But I'm not sure it's a solution for everybody. As a general matter, southern and central Africa are absolutely the most difficult development challenges of our times, obviously, not only because of these transport costs and you're landlocked and you're really disadvantaged that way, but because of HIV-AIDS, and I wish that I could tell you that I had a particular solution about investments in education when you have 25 percent of the work force HIV positive, but I don't. It's beyond my realm. So I'm ending on a bit of a sour note. I wish I could sort of say, this is the silver bullet for everybody, but that would be wrong. We haven't seen it work in landlocked countries as much as on coast economies. Now, on the specifics of education, I'll turn that over to Lynn.

SALINGER: Thanks a lot. I'm no one to speak on the specifics of education. However, I would observe that tertiary education in many developing countries has not necessarily done a lot to develop an entrepreneurially-oriented class of people who can dynamize the private sector, and so the collapse of a university education producing philosophers and literature experts is not a total loss. That's being somewhat facetious, obviously. There's a lot to be learned from within firms and to the extent that there are still companies operating, when you read the "Africa Can Compete" literature out of the Enterprise Development Group at the World Bank, you see that firms in that part of the world typically spend very little money on training, on research and development and on the kinds of things that would foster any kind of innovative thinking. And I guess, as a substitute for university education, again I would think about work force-based or firm-based training and development programs.

PARTICIPANT: I just wanted to press you a little bit on the landlocked country side. I know Jeffrey Sachs talks about this a lot and I still talk from personal experience. I'm a very small importer from Nepal. We only do about a million dollars a year so it's pretty small potatoes, but we find from Nepal, the air freight charges are about two and a half times as high as from Delhi. We just don't find that our major problem. And we've done sea exports from Bombay and we won't do that again. So that, I'm talking sort of medium- to high-priced women's garments, is what we're importing. And so the real question is, is that such a problem being landlocked or are we very unusual that it doesn't --

RADELET: Are you exporting?

PARTICIPANT: Importing.

RADELET: Are you exporting?

PARTICIPANT: No, I import. Well, I export from Nepal, import to the US.

RADELET: Right, OK.

SALINGER: And air freight.

PARTICIPANT: The freight costs from Delhi are about \$2.20 a kilo and it's nearly \$6.00 from Nepal, and we just find that the least of our problems.

RADELET: It's, what it does is, obviously it's more expensive than if you're on the coast.

PARTICIPANT: Right.

RADELET: If you're paying the higher transport costs, then you've got to pay less somewhere else to compete. Probably that means lower wages, I would guess, as a general rule. Now, is it possible to have slightly higher transportation costs, slightly lower wages and still compete? Yes. Can you do that on textiles where the margins are fairly large? Yes. Can you do it on electronics? No, because the margins are just too thin and when you add that transportation cost in there you're not going to be able to compete. So Nepal has done it in textiles a little bit; Zimbabwe had done it in textiles a little bit.

PARTICIPANT: Nepal's biggest export is carpets.

RADELET: Yeah, and Nepal does it in carpets where they have other sorts of comparative advantages as well. For other countries where the transport costs are even higher, and Rwanda is among the highest, Burundi's among the highest, forget it. The transport costs are just so high that you can't drop wages low enough to compete. So it's not necessarily prohibitive, and on landlocked actually, I want to step back a slightly different issue. By landlocked we mean access to markets, and that doesn't necessarily mean landlocked countries. Obviously, Austria and Switzerland have done fine, but they are not remote; they're in the middle of a big market and Poland and Latvia have done fine because they're sitting right on the edge of the European market. So the issue is sort of access to big markets rather than landlocked per se. But landlocked works pretty well as an approximation. So what it's going to do is raise your costs. Whether it's prohibitive or not depends on what those transport costs are relative to your wages. That's the issue.